FIRST DEVONIAN EXPLORATIONS LTD.

ANNUAL REPORT 1986

First Devonian Explorations Ltd. is a Calgary based Canadian controlled Corporation whose business is the exploration for, and the development and production of petroleum and natural gas reserves. The Corporation is primarily involved in Western Canada.

First Devonian has evolved from a non-operating low interest holding entity to one which both operates and has, in many cases, a controlling interest in its programs. Prospects are usually generated by the Corporation and then outside participants are brought in who provide carried interests to First Devonian.

CORPORATE INFORMATION

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DIRECTORS
R. Gordon Cormie
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Robert G. Jennings
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Gary W. Selby
Barbara Stitt
Alan G. Thompson

OFFICERS
Steven P. Dobrowolski
President

Gary W. Selby
Vice-President

R. Gordon Cormie
Secretary-Treasurer

LEGAL COUNSEL
MacKimmie Matthews
Calgary, Alberta

AUDITORS
Collins Barrow
Calgary, Alberta

REGISTRAR AND TRANSFER AGENT
Royal Trust Corporation of Canada
Calgary, Alberta

BANKER
National Bank of Canada
Calgary, Alberta

STOCK EXCHANGES
Alberta Stock Exchange (FDI)

Vancouver Stock Exchange (FDI)

ABBREVIATIONS USED:

Bbl — Barrel
Bcf — Billion Cubic Feet
MMcf — Million Cubic Feet
Mcf — Thousand Cubic Feet
10^3m^3 — Thousand Cubic Metres
m^3 — Cubic Metre

FIVE YEAR CORPORATE PROFILE

	1986	1985	1984	1983	1982
FINANCIAL					
Gross Revenues	**$1,741,525**	$ 1,369,889	$ 970,762	$ 605,889	$ 204,544
Operating and Royalties	**754,661**	562,007	347,626	249,592	85,650
General and Administrative	**278,890**	183,943	195,351	192,150	145,258
Interest	**171,697**	108,306	101,286	58,981	11,978
Cash Flow	**536,277**	515,633	326,499	105,166	(38,342)
Earnings (Loss)	**255,425***	122,039	74,897	(34,224)	(113,481)
Cash Flow per Share	**.12**	.14	.10	.03	(.01)
Earnings (Loss) Per Share	**.05***	.03	.02	(.01)	(.04)
Working Capital (Deficiency)	**(230,645)**	(1,720,721)	(440,581)	(240,488)	(194,070)
Long-Term Debt	**2,848,474**	1,625,000	1,225,000	750,000	—
Capital Expenditures	**1,965,930**	2,717,526	1,008,337	899,986	607,514
Shareholders' Equity	**2,080,397**	3,439,263	2,802,193	2,630,456	2,555,180
Total Assets	**6,840,210**	8,513,566	4,847,065	4,105,425	3,051,247
RESERVES					
Proved and Probable					
Oil — Bbl	**889,900**	710,404	751,600	473,585	171,900
— 10^3m^3	**141.5**	112.9	119.6	75.3	27.3
Gas — MMcf	**4,436**	3,478	1,920	1,709	1,618
— 10^3m^3	**125 600**	98 470	54 381	48 396	45 800
OPERATIONS					
Daily Oil Production — Bbl	**139.4**	75.4	51.80	28.10	18.20
Daily Oil Production — m^3	**22.2**	11.9	8.24	4.47	2.89
Daily Gas Production — Mcf	**101.2**	171.0	161.00	161.00	129.00
Daily Gas Production — 10^3m^3	**2.9**	4.8	4.56	4.56	3.65
LAND HOLDINGS					
Canada — Net Acres	**10,518**	7,113	3,986	3,368	2,255
Canada — Net Hectares	**4 259**	2 878	1 612	1 362	902
U.S.A. — Net Acres	**1,500**	1,500	8,812	10,812	10,402
U.S.A. — Net Hectares	**607**	607	3 525	4 325	4 161
ASSET VALUE					
15% Discount Factor					
Proven	**8,436,000**	9,090,000	8,246,300	6,429,200	3,445,000
Probable	**1,424,000**	2,408,000	1,389,000	1,381,800	1,307,500
TOTAL	**$9,860,000**	$11,498,000	$9,635,300	$7,811,000	$4,752,500
Number of Employees	**6**	5	5	4	4

*Before unusual items

REPORT TO SHAREHOLDERS

First Devonian Explorations Ltd. undertook an aggressive drilling program during last winter's drilling season to bring on stream a portion of its proven undeveloped oil reserves. The oil price collapse during the midst of this program had serious ramifications for the Corporation. This annual report to shareholders for fiscal 1986 documents the steps that have had to be taken to correct the problems resulting from the oil price fall and will outline the course that we will pursue to resume the growth experienced over the previous five years.

In an attempt to protect the shareholders of First Devonian from significant dilution involved with straight equity financing with depressed market prices, a combination of debt and equity financing was utilized in the development of certain low risk oil and gas holdings last year. Low oil prices caused our available bank financing to be curtailed which triggered a delay in available equity financing. This left the Corporation unable to pay certain unsecured creditors principally associated with our drilling program. Both the creditors and First Devonian's major investors were notified of the situation. A Court approved arrangement was ultimately approved by both the shareholders of the Corporation and unsecured creditors on December 9, 1986 under which financing was provided to First Devonian and a settlement reached with unsecured creditors. Acceptance by shareholders was unanimous for those voting, while 94 percent of the unsecured creditors, representing 96 percent of the amounts owed, approved the arrangement. The results of the arrangement include:

1) 3,127,000 Common Shares have been issued to unsecured creditors for a consideration of 35¢ per share thereby reducing trade payables by $1,096,278.

2) 1,096,278 First Preferred Shares have been issued to unsecured creditors for a consideration of $1.00 per share which further reduces trade payables by an additional $1,096,278. These shares bear a 10 percent non-cumulative dividend and are fully redeemable as well as retractable over an extended period of time.

3) Funding of two debentures by First Devonian's major investors has occurred. One debenture for $400,000 is non-convertible and bears interest at prime plus one percent. The second debenture is for $724,724 and is convertible into Common Shares at 15.4¢ per share for a total of 4,706,000 Common Shares. This convertible debenture is currently non-interest bearing. Both debentures are secured by certain oil and gas properties of the Corporation.

4) 4,706,000 Class A Shares have been issued to the investors to be outstanding during the term of the convertible debenture. These voting shares are to be redeemed for a nominal value by First Devonian as the convertible debenture is converted or paid out.

5) 410,536 Common Shares have been issued on a flow through basis to investors for a consideration of $1.00 per share.

Assuming conversion of the convertible debenture, the average price for all Common Shares that will be issued to unsecured creditors and investors is 27¢ per share. If the additional 700,000 flow through Common Shares subscribed for at $1.00 per share and issued to the investors during fiscal 1986 are included, the average cost is 33¢ per share.

To quote from our last year's Report to Shareholders, "Once cash flow figures allow the Company to internally finance its operations, dilution and the risk of debt financing will not have to be faced by the Company. Acceleration of our growth to this level is now our principle goal". Although we had anticipated prices falling to approximately $18.00 U.S. per barrel over time, we did not anticipate a rapid price drop to under $10.00 U.S. per barrel. The effects of this fall on the banking and investment community will last for some time even though prices have recovered somewhat and may stabilize in the meantime. The timing of the price fall could not have come at a worse time in First Devonian's development. However, after completing our arrangement, we believe that we can again begin the pattern of growth established in the past.

First Devonian's general and administrative expenses increased by $94,947 over the period due principally to legal expenses associated with our arrangement.

The Corporation implemented certain salary and benefit cutbacks during 1986. Due to the termination of our office lease, we expect to see a reduction in leasing costs this year. Our general and administrative expenses have never been excessive and we will continue to monitor them to maximize efficiency at as low a cost as possible.

The Corporation's philosophy continues to be to develop a larger oil and gas reserve base with higher working interests in fewer properties. We expect to internally generate and operate the majority of prospects as we have been doing in the past. This results in various operators fees and carried working interests accruing to First Devonian.

The development of long term high quality oil reserves was the main objective up until approximately the begin-

ning of fiscal 1986. To that end, we concentrated our efforts in north central Alberta. That strategy has benefited First Devonian in that we are not faced with rapidly depleting or low quality oil production. We have also commenced certain programs in southern Alberta for low cost, high deliverability gas reserves. We expect to continue this shift in emphasis over the next year.

Fiscal 1986 was highlighted by the following activities:

1) The first half of the year saw successful wells drilled in the Virginia Hills, Swan Hills and Judy Creek Areas. The Corporation participated in one dry hole during the year and farmed out a second location which was also abandoned. A total of seven oil wells and one gas well were drilled in fiscal 1986.

2) Midway through the year a joint venture company was acquired and a flow through share issue structured with our major investors.

3) The balance of the prospective lands on the McBride gas discovery were acquired through a land sale and farmin.

4) Wells were pipelined in the Judy Creek and Virginia Hills Areas. A battery was also under construction at year end in the Virginia Hills Area which has since reduced our operating expenses and will give greater flexibility for future development in the area.

Net proven plus probable oil reserves were up by 25 percent in 1986 to 889,900 barrels. Net proven plus probable gas reserves increased by 28 percent to 4.4 Bcf. Average daily production was also up to 139 barrels per day, an increase of 85 percent. Current production is approximately 150 barrels per day. Average daily gas production fell by 41 percent to 101 Mcf per day. Current gas production is approximately 750 Mcf per day as our McBride gas property commenced production during December of 1986. Although our oil production showed a significant increase in fiscal 1986, cash flow for the same period was up by only 4 percent to $536,277 due to the oil price collapse. Earnings before unusual items increased by 32 percent to $255,425.

Adoption of the new Canadian Institute of Chartered Accountants ("C.I.C.A.") guideline by First Devonian resulted in the Corporation taking a combined writedown of $4,910,300. The writedown is based on oil prices of $17.00 Canadian. Under the new C.I.C.A. guideline, with two cost centres having been established, a mandatory writedown of U.S. assets of $1,811,600 had to occur. We have also elected to take a writedown of $3,098,700 on our Canadian assets at this time. This election will serve to enhance earnings in the future and is not a reflection of actual asset values. At our upcoming shareholders meeting, a resolution may be introduced to offset the resultant deficit against share capital.

With the precipitous drop in oil and gas prices, First Devonian's plans for development of its properties and the focus of future activity have changed. The economics of drilling up certain properties and putting them on production are now not justifiable. The Corporation intends to utilize available cash flow and future financing to concentrate on:

1) developing specific oil and gas properties with immediate potential for cash flow,

2) further rationalizing the debt of the Corporation to a level that reflects current cash flow and the inherent instability in the industry due to fluctuating product prices,

3) further reducing relative general and administrative expenses, and

4) investigating potential acquisitions or mergers.

While a greater degree of caution will have to be exercised in future programs and the risk of debt financing closely monitored, we believe that with prices of $15.00 U.S. per barrel or greater that we will again resume our financial growth. Since it was critical for the Corporation to obtain additional financing and an agreement with creditors, both of which have been accomplished, we would like to pass along our thanks to both our major investors and creditors who lent their support during the past year.

Submitted on behalf of the Board of Directors.

Steven P. Dobrowolski
President

January 29, 1987

EXPLORATION AND DEVELOPMENT

Since 1983 First Devonian has concentrated on the exploration for and the development of low risk, high quality Canadian oil reserves. Over the past two years, the Corporation also began to emphasize the development of high deliverability, low cost gas reserves. The results achieved have steadily increased the reserve base of the Corporation.

DRILLING RESULTS

	For the Fiscal Year Ending In				
	1986	1985	1984	1983	1982
Canada:					
Oil	7	10	4	6	4
Gas	1	4	0	0	0
Dry	2	3	0	1	1
Injector	0	1	0	0	0
Total	10	18	4	7	5
U.S.A.:					
Oil	3	5	2	4	5
Gas	0	0	0	0	0
Dry	3	3	11	8	6
Total	6	8	13	12	11

MAJOR PROPERTIES

All of the Corporation's major oil and gas properties are located in Alberta. The following provides an outline of First Devonian's position in each of its major properties.

VIRGINIA HILLS, ALBERTA

First Devonian holds various working interests in 7040 gross acres (1632 net) of land in the Virginia Hills Area. The Corporation currently operates 7 producing Beaverhill Lake oil wells (2.7 net) on its holdings. An eighth well (0.1299 net) has been cased and completed as a potential Beaverhill Lake oil well. Five of the oil wells were tied into a central battery facility and pipelined into a sales oil line in the area this past summer. Deliveries through the new pipeline commenced in September of 1986. Since almost one half of the Corporation's oil production is from the Virginia Hills Area it is anticipated that the resultant lower operating costs from these expenditures will be significant for First Devonian.

SWAN HILLS, ALBERTA

First Devonian operates 7 Beaverhill Lake oil wells (3.72 net) in the Swan Hills Area. Two of these wells have been suspended due to low, uneconomic production rates. The Corporation has also drilled and cased as a potential Beaverhill Lake oil producer a well in 2-21-68-9 W5M in which it holds a 30.5 percent working interest. This well has recently been completed as a Beaverhill Lake oil producer. Current land holdings of First Devonian in the Swan Hills Area are 3680 gross acres (1750 net).

JUDY CREEK, ALBERTA

First Devonian holds an interest in 640 gross acres (174 net) in the Judy Creek Area. The Corporation operates 2 producing Beaverhill Lake oil wells (0.51 net) on these lands. It also holds a 24.5 percent working interest in a custom processing plant in the Judy Creek Area that treats and disposes of produced fluids.

McBRIDE, ALBERTA

The Corporation has acquired an interest in 4320 gross acres (1188 net) in the McBride Area. At calendar year end there were three shut-in multi-zone gas wells (1.10 net) on these lands operated by the Corporation. The bulk of First Devonian's gas reserves are situated on our McBride lands. The close proximity of the wells to an existing gas pipeline in the area will facilitate low cost tie-ins for these wells.

WILSON CREEK, ALBERTA

First Devonian holds a 5 percent working interest in 2 sections of land in the Wilson Creek Area. Two deep multi-zone gas wells have been completed on the lands and are to be placed on-stream by the operator when market conditions warrant. Prior to the development of the Corporation's McBride property, most of First Devonian's gas reserves were situated on these lands.

RESERVES AND PROPERTY VALUES

The Corporation's properties were last evaluated by independent engineering consultants as at 12 November 1985. Since that point in time the following material changes have occurred:

1) First Devonian acquired all of the assets of 497394 Ontario Ltd. which consisted of oil and gas interests in many properties operated by First Devonian.
2) pricing expectations for oil and gas have been substantially reduced,
3) certain reserves have been drilled up and placed on-stream, and
4) a battery and pipeline were constructed in the Virginia Hills Area where the bulk of the Corporation's oil production occurs.

First Devonian's in-house personnel have utilized the above revisions in estimating the oil and gas reserves and the future value for certain properties in which it holds interests. The effective date of the evaluation is July 31,1986. In addition, estimated values were assigned to undeveloped lands. The estimated net gas and oil reserves and future cash flows of the Corporation's interests after the deduction of all royalties, overrides, operating and capital costs, mineral taxes, but including Alberta royalty credit for life, and before corporate taxes are as follows:

PRODUCTION

First Devonian's current daily production is approximately 150 barrels per day and 750 Mcf per day. Historical production rates of the Corporation are as follows:

NET OIL AND GAS PRODUCTION

	For the Fiscal Year Ending In				
	1986	1985	1984	1983	1982
Daily Oil Production — Barrels	139	75	52	28	18
Daily Gas Production — Mcf	101	171	161	161	129

As of fiscal year end, First Devonian held interests in 26 producing oil wells, 1 producing gas well and 19 shut-in gas and oil wells in Canada. In the United States the Corporation held minor interests in 18 oil wells and 3 gas wells.

ESTIMATED RESERVES AND CASH FLOW

Reserve Category	Reserves				Present Value Of Future Cash Flow (M$)				
	Gas		Oil						
	10^6m^3	MMCF	10^3m^3	MSTB	0%	10%	12%	15%	20%
Proven	90.5	3196	118.5	745.4	23,175	11,082	9,876	8,436	6,716
Probable	35.1	1240	23.0	144.5	5,186	2,061	1,767	1,424	1,027
Sub-Total	125.6	4436	141.5	889.9	28,361	13,143	11,643	9,860	7,753
Undeveloped Land	6327 acres				136	136	136	136	136
TOTAL					28,497	13,279	11,779	9,996	7,889

The above represents the estimated potential value of the Corporation's oil and gas properties assuming no risk is attached to the forecasts.

The Corporation's net asset value after debt consideration and risking probable reserves is set out below:

NET ASSET VALUE

Asset Value (15% Discount Factor - 50% of probable reserves)		$9,284,000
Plus: Notes Receivable	$ 54,050	
	$ 54,050	$ 54,050
		$9,338,050
Less: Long Term Debt	$2,848,474	
Working Capital Deficiency	230,645	
	$3,079,119	$3,079,119
NET ASSET VALUE:		$6,258,931

FINANCIAL POSITION AND PROJECTIONS

First Devonian was unable to fund its 1986 capital expenditures through an expected increase in cash flow, equity financing and bank financing due to the drop in oil and gas prices. The arrangement reached with unsecured creditors and the financing provided by investors have enabled the Corporation to significantly reduce its debt and working capital deficiency at year end. Our current total debt position includes two debentures totalling $1,124,724, one of which is for $400,000 and is interest bearing and another for $724,724 which is currently interest free.

We will continue to emphasize applying available capital to debt reduction. However, if the economics of certain projects dictate, we will selectively pursue activities which enhance our cash flow. With fluctuating commodity prices, it becomes obvious that the ratio of debt levels to available cash flow should be reduced to a more conservative level.

Our cash flow figures should not be too adversely affected by current lower prices with gas production commencing from our McBride property and oil production being increased elsewhere. Since production from these new properties will only be for a portion of the year, we expect that our last two quarters will show improvement over our first two quarters this year. At current prices, cash flow per share figures should be lower for 1987 due to the dilutive effect of the additional shares issued to unsecured creditors and investors.

AUDITORS' REPORT

To the Shareholders
First Devonian Explorations Ltd.

We have examined the consolidated balance sheet of First Devonian Explorations Ltd. as at July 31, 1986 and the consolidated statements of loss and deficit and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests and other procedures as we considered necessary in the circumstances.

In our opinion, these consolidated financial statements present fairly the financial position of the company as at July 31, 1986 and the results of its operations and changes in its financial position for the year then ended in accordance with generally accepted accounting principles applied, except for the change in the method of accumulating exploration and development expenditures as explained in note 1(j) to the financial statements, on a basis consistent with that of the preceding year.

Calgary, Alberta
October 31, 1986, except as to Note 10,
which is as of January 26, 1987

COLLINS BARROW
CHARTERED ACCOUNTANTS

CONSOLIDATED BALANCE SHEET

JULY 31, 1986

	1986	1985
ASSETS		
Current assets		
Accounts receivable	**$1,680,694**	$1,595,282
Notes receivable (note 3)	**54,050**	65,250
Property and equipment (note 4)	**5,105,466**	6,853,034
	$6,840,210	$8,513,566
LIABILITIES		
Current liabilities		
Bank overdraft	**$ 25,192**	$ 217,202
Accounts payable and accrued liabilities	**1,109,897**	3,098,801
Current portion of long-term debt (note 5)	**776,250**	—
	1,911,339	3,316,003
Long-term debt (note 5)	**2,848,474**	1,625,000
Deferred income taxes	**—**	133,300
SHAREHOLDERS' EQUITY		
Share capital (note 6)	**6,730,286**	3,630,577
Deficit	**(4,649,889)**	(191,314)
	2,080,397	3,439,263
	$6,840,210	$8,513,566

Approved on behalf of the Board,

, Director

, Director

CONSOLIDATED STATEMENT OF LOSS AND DEFICIT

YEAR ENDED JULY 31, 1986

	1986	1985
Revenue		
Oil and gas sales	$ 1,460,655	$1,178,623
Alberta royalty tax credit	108,464	66,692
Operator's fees and other	172,406	124,574
	1,741,525	1,369,889
Expenses		
Production	517,807	374,468
Royalties	236,854	187,539
General and administrative	278,890	183,943
Interest on long-term debt	171,697	108,306
	1,205,248	854,256
Working capital generated from operations	536,277	515,633
Charges not requiring working capital		
Depletion	220,600	253,000
Depreciation	60,252	69,394
	280,852	322,394
Earnings before unusual items and income taxes	255,425	193,239
Unusual items (note 9)		
Write-down of petroleum and natural gas leases and rights in Canada	3,098,700	—
Write-down of petroleum and natural gas leases and rights in the U.S.	1,811,600	—
	4,910,300	—
Earnings (loss) before income taxes	(4,654,875)	193,239
Deferred income taxes (recovered) (note 8)	(196,300)	71,200
Net earnings (loss)	(4,458,575)	122,039
Deficit, beginning of year	(191,314)	(313,353)
Deficit, end of year	$(4,649,889)	$ (191,314)
Earnings per share excluding unusual items and income taxes	$ 0.05	$ 0.05
Earnings (loss) per share	$ (0.96)	$ 0.03
Cash flow per share	$ 0.12	$ 0.14

CONSOLIDATED STATEMENT OF CHANGES IN FINANCIAL POSITION
YEAR ENDED JULY 31, 1986

	1986	1985
Working capital was provided by		
Current operations	**$ 536,277**	$ 515,633
Increase in long-term debt	**1,223,474**	400,000
Petroleum incentive grants	**23,467**	444,147
Issuance of share capital	**3,303,563**	556,000
Reclassification of long-term accounts receivable	**—**	62,722
Decrease in notes receivable	**11,200**	—
	5,097,981	1,978,502
Working capital was used for		
Acquisition of property and equipment	**1,989,397**	3,161,673
Issuance of notes receivable	**—**	56,000
Share capital issuance costs	**203,854**	40,969
Net assets acquired on purchase of subsidiary, including working capital deficiency of $1,204,654	**1,414,654**	—
	3,607,905	3,258,642
Increase (decrease) in working capital	**1,490,076**	(1,280,140)
Working capital deficiency, beginning of year	**(1,720,721)**	(440,581)
Working capital deficiency, end of year	**$ (230,645)**	$(1,720,721)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

JULY 31, 1986

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The consolidated financial statements of the Company are stated in Canadian dollars and have been prepared in accordance with accounting principles generally accepted in Canada which, in the case of the Company, conform in all material respects with International Accounting Standards. The significant accounting policies are summarized below:

a) Principles of consolidation

The consolidated financial statements include, in addition to the accounts of the Company, the accounts of its wholly-owned subsidiaries, First Devonian Explorations Inc., Barracuda Petroleum Inc., and 497394 Ontario Ltd.

b) Exploration and development costs

The Company follows the full cost method of accounting for exploration and development expenditures, wherein all costs related to the exploration for and the development of oil and gas reserves are initially capitalized. Costs capitalized include land acquisition costs, geological and geophysical expenditures, rentals on undeveloped properties, costs of drilling productive and non-productive wells, together with overhead and interest directly related to exploration and development activities. Proceeds on minor property sales are credited to the net book value of the property and equipment. Gains or losses on major property sales are normally recognized in the statement of loss.

Exploration and development costs are allocated to two cost centres, namely, Canada and the United States.

Costs capitalized in the cost centres are depleted on the composite unit-of-production method based on estimated proven oil and gas reserves as determined by independent and Company engineers.

In applying the full cost method, the Company calculates a ceiling test which restricts the capitalized cost less accumulated depletion and depreciation for each cost centre from exceeding an amount equal to the estimated undiscounted value of future net revenues from proven oil and gas reserves, based on current prices and costs, and after deducting estimated future general and administrative expenses, financing costs and income taxes for each cost centre. In calculating the above cost centre ceiling tests, gas was converted to oil on a 7 MCF to 1 BBL equivalent basis and $17.00 Canadian per barrel of oil was used as the current price of oil.

c) Depreciation

Lease and well equipment are depreciated on the composite unit-of-production method. Other equipment is depreciated on the declining balance method at 20% per annum.

d) Joint venture accounting

Substantially all of the exploration and production activities of the Company are conducted jointly with others and accordingly these consolidated financial statements reflect only the Company's proportionate interest in such activities.

e) Net loss per share

Net loss per share has been calculated using the weighted average number of common shares of 4,654,040 outstanding during the year. The exercise of share options or the conversion of the convertible debenture would not be dilutive.

f) Cash flow per share

Cash flow per share refers to working capital generated from operations, and it has been calculated using the weighted average number of common shares of 4,654,040 outstanding during the year.

g) Petroleum Incentive Program

Petroleum incentive grants earned under Petroleum Incentive Programs have been deducted from the cost of the related asset.

h) Foreign currency translation

The Company follows the temporal method of translation whereby foreign currency accounts and operations are translated to Canadian dollars on the following basis: monetary items at the rate of exchange at the year-end; other assets and liabilities at the historical rate of exchange. The items in the statement of loss are translated at the average rates of exchange prevailing during the year except for depletion and depreciation, which are translated at the same rates as used for the related assets. Material translation gains and losses on monetary items are included in the statement of loss.

i) Flow through shares

The Company has incurred exploration costs under certain subscription agreements whereby the income tax benefits of such costs are retained by the subscribers. Shares issued under such agreements are carried at a value based on actual monies received while related property and equipment acquired are carried at laid down cost.

j) Change in accounting policy

The Company prospectively adopted two cost centres, Canada and the United States, in respect of the costs capitalized under the full cost method of accounting for petroleum and natural gas properties. Previously the Company utilized one cost centre, that being North America. The change in policy was made to conform with the Full Cost Accounting Guideline as recommended by the Canadian Institute of Chartered Accountants as explained in note 9.

2. ACQUISITION

Effective December 30, 1985, the Company acquired 100% of the outstanding shares of 497394 Ontario Ltd. for a cash payment of $210,000.00. The assets of 497394 Ontario Ltd. consist mainly of oil and gas properties located in the Province of Alberta. Details of this acquisition, which has been accounted for by the purchase method, are as follows:

Working capital deficiency	$(1,204,654)
Property and equipment	1,477,654
	273,000
Deferred income taxes	63,000
	$ 210,000

Results of operations for the period from acquisition December 30, 1985 to July 31, 1986 have been included in the consolidated statement of loss.

3. *NOTES RECEIVABLE*

Pursuant to share purchase options exercised, the Company has advanced funds to certain employees to enable them to purchase common shares from treasury. The advances are due in 1988, are non-interest bearing and are secured by promissory notes.

4. *PROPERTY AND EQUIPMENT*

Property and equipment consists of the following:

	1986			1985
	Cost	Accumulated Depletion and Depreciation	Net	Net
Petroleum and natural gas leases and rights including exploration and development thereon	$ 9,081,175	$4,973,700	$4,107,475	$5,766,499
Lease and well equipment	1,858,979	896,400	962,579	1,050,689
Other equipment	84,779	49,367	35,412	35,846
	$11,024,933	$5,919,467	$5,105,466	$6,853,034

During the year, the Company capitalized general and administrative expenses in the amount of $241,079 (1985 - $235,260) and interest on long-term debt in the amount of $57,232 (1985 - $36,102).

5. *LONG-TERM DEBT*

Long-term debt is comprised of the following:

	1986	1985
Bank production loan	$2,500,000	$1,625,000
Non-convertible demand debenture	400,000	—
Convertible demand debenture	724,724	—
	3,624,724	1,625,000
Less: Portion due within one year	776,250	—
	$2,848,474	$1,625,000

a) The bank production loan bears interest at one percent over a Canadian chartered bank's prime lending rate and is secured by a $5,000,000 floating charge debenture over the assets of the Company, a general assignment of book debts, an assignment of accounts receivable, an assignment of shares of the Company's subsidiaries, an assignment of certain monies under a specified contract and by certain oil and gas properties.

The estimated principal payments due on the bank production loan are as follows:

1987	$ 776,250
1988	580,419
1989	450,416
1990	371,834
1991	246,504
Subsequent to 1991	74,577
	$2,500,000

b) The non-convertible demand debenture bears interest at one percent over a Canadian chartered bank's prime lending rate, beginning January 22, 1987, and is secured by certain oil and gas properties (note 10).

c) The convertible demand debenture is convertible, at any time, into 4,706,000 common shares of the Company and is secured by certain oil and gas properties. The debenture is non-interest bearing unless the debenture holder makes demand for repayment, at which time the debenture will bear interest at one percent over a Canadian chartered bank's prime lending rate (note 10).

The management of the Company does not anticipate that the debenture holders will demand principal repayments within the upcoming fiscal year. As a result, the debentures have been classified as long-term liabilities.

6. *SHARE CAPITAL*

a) Authorized (note 10)

Unlimited number of voting common shares without nominal or par value
4,706,000 Class A voting shares without nominal or par value
1,110,113 First preferred non-voting shares without nominal or par value

b) Issued and to be issued

	Number	Stated Value
Common Shares		
Balance, July 31, 1985	4,125,967	$3,998,640
Issued pursuant to flow-through share agreement	700,000	700,000
Obligation to issue shares pursuant to flow-through share agreement	410,536	410,536
Obligation to issue shares to Company's unsecured creditors under Company's formal arrangement (note 10)	3,127,000	1,096,278
Balance, July 31, 1986	8,363,503	6,205,454

Class A Shares		
Balance, July 31, 1985	—	—
Obligation to issue shares to investors under Company's formal arrangement (note 10)	4,706,000	471
Balance, July 31, 1986	4,706,000	471
First Preferred Shares		
Balance, July 31, 1985	—	—
Obligation to issue shares to Company's unsecured creditors under Company's formal arrangement (note 10)	1,096,278	1,096,278
Balance, July 31, 1986	1,096,278	1,096,278
Less: Share issuance costs		571,917
		$6,730,286

c) The Class A shares will be issued to investors in conjunction with the $724,724 convertible debenture under the Company's formal arrangement. The shares are redeemable from time to time either upon the repayment of all or a portion of the outstanding principal amount of the convertible debenture or upon conversion of the Class A shares into common shares of the Company, on a basis that one Class A share will be redeemed for each portion of the outstanding principal amount of the convertible debenture equal to $0.154 which is either repaid or converted into common shares.

d) The first preferred shares bear a 10% non-cumulative dividend accruing from and after July 31, 1986. The shares are retractable at a retraction value of $1.00 per share at the option of the holder after 5 years at a rate of 5% of the initial number of such shares held by each holder per year for the next ensuing 10 years and at the rate of 10% of such shares per year for the following 5 years. In addition, the shares are fully redeemable by the Company at a redemption value of $1.00 per share at the option of the Company at any time.

e) Stock option plan

As at July 31, 1986, 52,000 shares have been reserved under the Company's stock option plan. Options outstanding consist of 50,000 shares exercisable at $0.60 per share, expiring in 1987, and 2,000 shares exercisable at $0.51 per share, expiring in 1987.

7. *RELATED PARTY TRANSACTIONS*

The Company has a participation plan whereby certain officers and employees are allowed to participate up to a total of 10% of the Company's working interest in new ventures. Participation is on standard industry terms with the officers and employees required to finance their working interests.

Included in accounts receivable at July 31, 1986 was $178,679 owing from certain officers and employees in connection with their working interest participation.

8. *INCOME TAXES*

Income tax expense, comprised exclusively of deferred income taxes, differs from that which would be expected from applying the effective Canadian federal and provincial income tax rates to earnings before income taxes. Details of the changes are set out below:

	1986	1985
Effective Canadian income tax rate	47%	47%
Computed "expected" income taxes (recoverable)	$(2,170,300)	$ 90,800
Increase (decrease) in income taxes resulting from:		
Tax benefit not recognized on the write-down of petroleum and natural gas leases and rights due to a lack of virtual certainty of realization	2,021,800	—
Non-deductible crown payments, net of provincial tax credit	43,300	32,600
Resource allowance and earned depletion	(91,100)	(81,000)
Other	—	28,800
Deferred income taxes (recovered)	$ (196,300)	$ 71,200

9. *UNUSUAL ITEMS*

As explained in note 1(j), the Company has adopted Canada and the United States as the two cost centres for the capitalization of costs under the full cost method of accounting for petroleum and natural gas properties. In applying the ceiling test as discussed in note 1(b), costs in excess of the estimated value of property and equipment in each of the two cost centres in the amount of $3,098,700 in Canada and $1,811,600 in the U.S. have been written off against current earnings. The ceiling test used a price of $17.00 Canadian per barrel for the current price of oil.

10. *SUBSEQUENT EVENT*

On December 9, 1986, the Company's shareholders and unsecured creditors approved a formal settlement arrangement under Section 186 of the Business Corporations Act of Alberta. The arrangement between the Company and its unsecured creditors resulted in the following corporate actions:

a) The Company adopted Articles of Amendment which had the effect of designating the existing shares of the Company as "Common Shares", creating a preferred class of shares known as the "First Preferred Shares" and creating a new class of shares known as "Class A shares" (note 6).

b) The issuance of 3,127,000 common shares of the Company to unsecured creditors of the Company in satisfaction of $1,096,278 of debt (note 6).

c) The issuance of 1,096,278 first preferred shares of the Company to unsecured creditors of the Company in satisfaction of $1,096,278 of debt (note 6).

d) The borrowing of $1,124,724 from investors through the issuance of a convertible demand debenture in the principal amount of $724,724, 4,706,000 Class A shares of the Company and a non-convertible demand debenture in the principal amount of $400,000 (notes 5 and 6).

e) The payment of $765,533 to unsecured creditors of the Company in satisfaction of $765,533 of debt.

As the formal settlement arrangement was made retroactively effective as of July 31, 1986, the above transactions have been reflected in the Company's July 31, 1986 financial statements.

11. *SEGMENTED INFORMATION*

The Company operates exclusively in the oil and gas industry and as such is defined as having a dominant industry segment.

The Company's exploration, development and production activities can be geographically segmented as follows:

	1986		
	Canada	United States	Total
Oil and gas sales	$1,395,037	$ 65,618	$ 1,460,655
Operating profit	$ 774,043	$ 40,415	814,458
Operator's fees and other			$ (172,406)
General and administrative			278,890
Interest on long-term debt			171,697
Depletion			220,600
Depreciation			60,252
Deferred income taxes (recovered)			(196,300)
Unusual items			4,910,300
			5,273,033
Net loss			$(4,458,575)
Property and equipment	$5,025,085	$ 80,381	$ 5,105,466
Other	1,687,741	47,003	1,734,744
Total identifiable assets	$6,712,826	$ 127,384	$ 6,840,210

	1985		
	Canada	United States	Total
Oil and gas sales	$1,113,777	$ 64,846	$ 1,178,623
Operating profit	$ 655,068	$ 28,240	$ 683,308
Operators's fees and other			(124,574)
General and administrative			183,943
Interest on long-term debt			108,306
Depletion			253,000
Depreciation			69,394
Deferred income taxes			71,200
			561,269
Net earnings			$ 122,039
Property and equipment	$5,005,204	$1,847,830	$ 6,853,034
Other	1,634,439	26,093	1,660,532
Total identifiable assets	$6,639,643	$1,873,923	$ 8,513,566

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